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UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

WESTERN DIVISION

NATIONAL CREDIT UNION ADMINISTRATION BOARD AS CONSERVATOR FOR WESTERN CORPORATE FEDERAL CREDIT UNION, Plaintiff, vs. ROBERT A. SIRAVO, et al., Defendants.	No. CV 10-01597 GW (MANx) **MEMORANDUM IN SUPPORT OF DEFENDANTS' MOTION TO DISMISS PLAINTIFF'S FIRST AMENDED COMPLAINT** Honorable George H. Wu Courtroom 10 312 North Spring Street Date: December 20, 2010 Time: 8:30 a.m. Courtroom: Los Angeles, 10

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I. INTRODUCTION AND SUMMARY OF ARGUMENT.

This motion to dismiss, brought by 11 former unpaid volunteer directors and one former officer, attacks the legal sufficiency of the First and Second Claims in the First Amended Complaint, Doc. 84 ("FAC"), filed by the National Credit Union Administration Board ("NCUA"); these 12 defendants (the "Defendants") are not parties to the Third through Sixth Claims.

The First Claim, for negligent breach of fiduciary duty, attacks investment decisions made by Western Federal Corporate Credit Union ("WesCorp"). It focuses almost exclusively on the *content* and *result* of those decisions, and only incidentally on the *process* by which those decisions were made. In so doing, this claim fails to plead – as it must – an exception to California's Business Judgment Rule, which insulates the content and result of business decisions – even risky decisions – from judicial review so long as the process was rational. Here, the FAC alleges nothing that undermines the rationality of Defendants' processes. Nor does the First Claim allege any fraud, bad faith or conflicts of interest, much less the "gross overreaching" needed to overcome the Business Judgment Rule. Indeed, the FAC candidly admits the careful processes by which Defendants made their decisions, and fails even to suggest that these processes fell short of the detailed legal requirements set by the NCUA's statutes and regulations, which expressly allow investments of the sort made here and expressly set forth how directors were to approach their investment decisions.

The Second Claim attacks the same investments, this time labeling them grossly negligent, but with nothing more by way of factual allegations to support that theory. This claim has other legal infirmities as well. The statute under which the NCUA brings this claim sets a federal floor: it applies only if state law limits liability to levels of culpability more serious than gross negligence, and then it looks to state law for the contours of gross negligence. That federal floor has no application in California. But if it did, the NCUA still would have

no claim, because its factual allegations do not come anywhere near the showing of "want of even scant care," "extreme departure from the ordinary standard of conduct," "reckless indifference," "deliberate disregard" or conduct "without the bounds of reason" required to state a claim of gross negligence against directors.

Both claims also fail to satisfy the statute of limitations as to three Defendants (Cheney, Rhamy and Updike) because all left WesCorp's Board early in 2006, before the beginning of the applicable limitations periods.

II. STATEMENT OF THE CASE.

A. The parties.

The NCUA is an independent federal agency created pursuant to 12 U.S.C. § 1752a(a). The NCUA alleges that on March 19, 2009 it placed WesCorp into a conservatorship pursuant to 12 U.S.C. § 1786(h)(1) and succeeded to the rights of WesCorp and its members, including the right to bring this case against WesCorp's former directors and officers. FAC ¶ 1.

The 16 named defendants are some but not all of the former unpaid volunteer directors and officers of WesCorp. FAC ¶¶ 6-21. The movants here are 11 former directors and one former officer (Robert Burrell). *Id.* What these 12 defendants have in common is that all are named in the First and Second Claims (the "Investment Claims"), but not in the Third through Sixth Claims (the "SERP Claims").

B. Procedural history.

The NCUA took over WesCorp and placed it into a conservatorship on March 19, 2009. FAC ¶ 1. Unlike the usual private plaintiff, who must prepare a complaint with little or no access to the defendants' records, the NCUA had daily access to WesCorp's books and records – and to its employees – for a year and a half before it filed the FAC. It has had plenty of time and opportunity to investigate and develop its claims, and no reason not to file a detailed and specific complaint satisfying *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544,

127 S. Ct. 1955 (2007), and *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009).

The seven original plaintiffs filed this case in Superior Court in November 2009. The NCUA intervened and then removed the case to this Court. Doc. 1. The NCUA and the original plaintiffs fought over who owned the claims and should control the litigation (Doc. 31, 40-43); the Court ruled largely in favor of the NCUA (Doc. 66). After further disagreements between the NCUA and the original plaintiffs, and a status conference (Doc. 80-81), the NCUA filed the FAC and the original plaintiffs withdrew from the case (Doc. 84-85).

C. The FAC's allegations about the Investment Claims.

The FAC asserts two claims against Defendants: negligent breach of fiduciary duty and gross negligence. FAC ¶¶ 114, 121. Both claims principally attack the *content and result* of Defendants' decisions, as opposed to the *process* by which Defendants made those decisions. As discussed below, the law treats the *process* of decision-making differently from the *content* and *results* of those decisions, hence this memorandum distinguishes between them.

The FAC's allegations about the content of Defendants' business decisions: The FAC alleges that WesCorp changed its business model starting in 2002, abandoning its "traditional business model" in favor of growth in assets, borrowing and interest income from investments. FAC ¶¶ 25-30, 44-53. WesCorp sought higher yields on its investments and therefore bought proportionately more mortgage-backed securities ("MBS") issued by "the world's leading investment banks" (which the FAC calls "private-label MBS") and proportionately less MBS issued by the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"), the two government-sponsored enterprises that the federal government put into conservatorship in September 2008. FAC ¶¶ 32, 55.

In addition to buying more MBS underwritten by "leading investment banks" and less issued by Fannie Mae and Freddie Mac, Defendants also

temporarily increased the concentration of AA-rated (as opposed to AAA-rated) MBS until 2005 but then decreased the concentration of AA (in favor of AAA) until 2007, when WesCorp ceased buying MBS altogether. FAC ¶¶ 62-64. The FAC admits that all private-label MBS that WesCorp purchased were rated AAA or AA (the highest two ratings) by Moody's or S&P. FAC ¶ 32. The FAC does not suggest that WesCorp ever bought lower-rated or lower tranche MBS.[1]

The FAC does not question the legality of these investments. Nor could it, for the Federal Credit Union Act expressly contemplates and authorizes such investments. 12 U.S.C. § 1757(7)(E) (permitting investments in MBS issued by Fannie and Freddie), § 1757(15)(B) (permitting investments in other MBS). So too do the NCUA's regulations. *See* 12 C.F.R. § 704.5(c) (Mar. 19, 1997) and Part 704, Appx. B (Oct. 25, 2002). The FAC's main "content" allegation is that Defendants bought too much "Option ARM" MBS.[2] FAC ¶¶ 30-31, 113, 121. The FAC admits that WesCorp adopted policies specifying concentration limits for various types of securities and periodically amended the limits. FAC ¶ 69. The FAC also admits that WesCorp stayed within those limits. FAC ¶¶ 69, 73.

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[1] The FAC does not explain this point, but the case law does. Typically an offering of MBS consists of as many as a dozen classes, or "tranches." Investors purchasing the least risky or "senior" tranches receive lower interest; investors purchasing the junior tranches receive more interest to compensate them for bearing more risk. The ratings agencies (such as Moody's and S&P) issue separate ratings for each tranche. Thus, a senior tranche could be AAA, whereas a junior tranche could be BB or even unrated "equity." *Merrill Lynch Int'l v. XL Capital Assur. Inc.*, 564 F. Supp. 2d 298, 300 (S.D.N.Y. 2008); *In re Sec. Capital Assur. Secs. Litig.*, No. 07 Civ. 11086 (DAB), 2010 U.S. Dist. LEXIS 33954, *10-11 (S.D.N.Y. Mar. 10, 2010). The FAC alleges that WesCorp bought only AAA- and AA-rated MBS, and started moving out of AA after 2005. FAC ¶¶ 62-64.

[2] The FAC does not define this term either. Option ARMs are adjustable rate mortgages ("ARMs") in which the borrower is given some latitude (hence the "Option") to say how much he or she will pay each month. *See In re Countrywide Fin. Corp. Sec. Litig.*, 588 F. Supp. 2d 1132, 1150 (C.D. Cal. 2008).

The FAC faults WesCorp for not adopting a concentration limit specifically for Option ARM MBS, but does not allege facts showing the need for a limit was apparent when WesCorp was buying Option ARMs – in other words, that "red flags" were flying which Defendants should have spotted. FAC ¶ 70. (WesCorp ceased buying MBS altogether by mid 2007. FAC ¶ 64.)

The FAC's allegations about the process by which Defendants made their business decisions: The FAC's allegations about process are few and far between, and far less specific than the FAC's admissions about what WesCorp did right. Significantly, the FAC does *not* allege that WesCorp ever violated any of the NCUA's detailed regulations or other directives prescribing how to analyze and monitor investments (about which more below).

The FAC admits that Defendants received detailed information about WesCorp's investment portfolio, set appropriate concentration limits and lived within those limits, bought only high-rated investments (mostly AAA), monitored trends, lowered their exposure to riskier investments (nothing below AA) when risks emerged and got out of the market altogether long before most on Wall Street. *E.g.*, FAC ¶¶ 32, 63-66, 69-70, 74-77. The FAC also admits that WesCorp classified and tracked MBS investments by rating (AAA and AA) and FICO score (prime, alt-A, and subprime), and used the bond rating of investments to track tranche positions. FAC ¶¶ 71-72.

The FAC admits that each year Defendants adopted a budget that contained detailed information about projected expenses and projected fee income, including monthly projections of investment income, investment expense and net interest income. FAC ¶ 65. The FAC admits that Defendants regularly attended meetings of WesCorp's Board of Directors and its Asset and Liability Committee ("ALCO"), and thus regularly received information about the state of the economy, the investment climate and WesCorp's investment strategy. FAC ¶ 74. The FAC also admits that Defendants received and

considered presentations on Option ARM MBS and took affirmative steps to adjust WesCorp's investment strategy based on the information received at ALCO meetings (*e.g.*, starting to get out of AA in 2005). FAC ¶¶ 62-64, 75-77.

These admissions aside, the FAC's allegations about process are either completely conclusory (FAC ¶ 113) and therefore to be disregarded, *see Iqbal*, 129 S. Ct. at 1949; *Moss v. U.S. Secret Service*, 572 F.3d 962, 969 (9th Cir. 2009), or else nit-pick the format of the reports that the Board received from management. FAC ¶ 71-72, 114(e) (reports focused on rating agencies' rating rather than tranche level or whether underlying loans were Option ARMs).

The FAC's allegations about the results of the business decisions: The FAC alleges that WesCorp failed because it "was required to record losses of $6.8 billion in its investment portfolio" (FAC ¶ 33) and that Defendants caused losses "not fully ascertained but in excess of $1 billion" (FAC ¶¶ 117, 123). The FAC does not allege whether the MBS currently are delinquent on payments, or whether any MBS actually have been sold at a loss.

III. ARGUMENT.

A. The FAC's First Claim does not state a claim for negligent breach of fiduciary duties because it fails to allege facts sufficient to overcome California's Business Judgment Rule.

1. California's Business Judgment Rule governs the First Claim.

A federal statute, 12 U.S.C. § 1787(h), defines the liability of directors and officers of a credit union. That statute permits the NCUA to look to state law, so long as state law requires no more culpability than gross negligence. *See Gully v. NCUA*, 341 F.3d 155, 165 (2d Cir. 2003) (applying New York's corporate fiduciary duty statute and common law to an officer's breach of fiduciary duty); *cf. Atherton v. FDIC*, 519 U.S. 213, 215-16, 117 S. Ct. 666, 669-70 (1997) (construing 12 U.S.C. § 1821(k), which is the FDIC's analogue to § 1787(h)). California law meets this statutory standard. *FDIC v. Castetter*, 184 F.3d 1040,

1043-44 (9th Cir. 1999). Thus, the Court should look to California law in determining whether the First Claim states a claim.

California follows (and indeed has codified, Cal. Corp. Code §§ 309, 7231) the Business Judgment Rule. That Rule insulates directors from liability for simple negligence (which is what the First Claim alleges, FAC ¶¶ 35, 114) so long as the directors acted in good faith, without conflicts of interest, and did what they believed to be in the best interest of the corporation. *Castetter*, 184 F.3d at 1044. The Rule "protect[s] well-meaning directors who are misinformed, misguided, and honestly mistaken" from judicial second-guessing. *Id.* at 1046. Or, as California courts express it, "The business judgment rule 'sets up a presumption that directors' decisions are based on sound business judgment. This presumption can be rebutted only by a factual showing of fraud, bad faith or gross overreaching.'" *Ritter & Ritter Pension & Profit Sharing Plan v. Churchill Condo. Ass'n*, 166 Cal. App. 4th 103, 123, 82 Cal. Rptr. 3d 389, 403 (2008) (citations omitted).

Berg & Berg Enters., LLC v. Boyle, 178 Cal. App. 4th 1020, 1045, 100 Cal. Rptr. 3d 875, 897 (2009) explains California's Business Judgment Rule:

> [T]he common law rule "has two components – one which immunizes directors from personal liability if they act in accordance with its requirements, and another which insulates from court intervention those management decisions which are made by directors in good faith in what the directors believe is the organization's best interest. Only the first component is embodied in Corporations Code section 309." The broader rule is "'"a judicial policy of deference to the business judgment of corporate directors in the exercise of their broad discretion in making corporate decisions."' [It] is based on the premise that those to whom the management of a business organization has been entrusted, and not

> the courts, are best able to judge whether a particular act or transaction is helpful to the conduct of the organization's affairs or expedient for the attainment of its purposes. The rule establishes a presumption that directors' decisions are based on sound business judgment, and it prohibits courts from interfering in business decisions made by the directors in good faith and in the absence of a conflict of interest. "'**A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be "attributed to any rational business purpose**."'"

Id. at 1045 (emphasis added) (citations omitted).

To be sure, a proper complaint can allege facts sufficient to overcome the Business Judgment Rule. But the standard is high, because the presumption favors and protects the defendants' business judgment. As the *Berg & Berg* court explained, a plaintiff must allege facts – not conclusions – sufficient to establish an exception to the Business Judgment Rule. And to do so:

> [M]ore is needed than "conclusory allegations of improper motives and conflict of interest. Neither is it sufficient to generally allege the failure to conduct an active investigation, in the absence of (1) allegations of facts which would reasonably call for such an investigation, or (2) allegations of facts which would have been discovered by a reasonable investigation and would have been material to the questioned exercise of business judgment." In most cases, "the presumption created by the business judgment rule can be rebutted only by affirmative allegations of facts which, if proven, would establish fraud, bad faith, overreaching or an unreasonable failure to investigate material facts. **Interference with the discretion of directors is not warranted in doubtful cases**."

> … **the failure to sufficiently plead facts to rebut the business judgment rule or establish its exceptions may be raised on demurrer, as whether sufficient facts have been so pleaded is a question of law**.

Id. at 1045-46 (emphasis added) (citations omitted). Other courts also have dismissed complaints on the ground that they do not allege facts sufficient to rebut the Business Judgment Rule. *McMichael v. United States Filter Corp.*, No. EDCV 99-182 VAP (MCx), 2001 U.S. Dist. LEXIS 3918, at *40-*43 (C.D. Cal. Feb. 23, 2001); *Lee v. Interinsurance Exchange*, 50 Cal. App. 4th 694, 711-17, 57 Cal. Rptr. 2d 798, 808-13 (1996); *Barnes v. State Farm Mut. Auto. Ins. Co.*, 16 Cal. App. 4th 365, 378-79, 20 Cal. Rptr. 2d 87, 94-96 (1993); *Fairchild v. Bank of Am. Nat. Trust & Sav. Asso.*, 192 Cal. App. 2d 252, 256-58, 13 Cal. Rptr. 491, 492-94 (1961); *Findley v. Garrett*, 109 Cal. App. 2d 166, 177-79, 240 P.2d 421, 427-30 (1952).

Before turning to the FAC's allegations, one other aspect of the Business Judgment Rule merits mention. The Rule focuses mainly on the *process* by which directors make business judgments, and not the *content* or *results* of those decisions themselves. *See* Cal. Corp. Code § 309. California cases such as *Berg & Berg* draw this distinction, but it is perhaps most trenchantly stated in a recent Delaware decision involving (as here) a financial institution's decision to invest in billions of dollars of MBS.

In re Citigroup Inc. Shareholder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009) dismissed a shareholder derivative action alleging that Citigroup directors breached their fiduciary duties by exposing Citigroup to $55 billion worth of MBS. In dismissing the action, the Chancery Court focused entirely on the *process* by which the directors had made their investment decision, and not on the *content* of that decision, explaining:

> What should be understood, but may not widely be understood by courts or commentators who are not often required to face such questions, is that compliance with a director's duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational", provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests. To employ a different rule – one that permitted an "objective" evaluation of the decision – would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests. Thus, the business judgment rule is process oriented and informed by a deep respect for all good faith board decisions.

Id. at 127 (quoting *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967-68 (Del. Ch. 1996) (emphasis omitted)).

2. The FAC does not allege facts sufficient to overcome California's Business Judgment Rule.

The FAC does not allege facts sufficient to meet the standards outlined above. Indeed, it scarcely tries. It focuses almost entirely on the *content* of the directors' decisions (to approve the purchase of mortgage-backed securities, see FAC ¶¶ 25-30, 45-53) and says almost nothing about the *process* of making those decisions, beyond admitting that Defendants received detailed information, set appropriate limits and lived within those limits, bought only high-rated

investments (mostly AAA), monitored trends, lowered their exposure to riskier investments when risks emerged and got out of the market altogether long before most on Wall Street. *E.g.*, FAC ¶¶ 32, 63-66, 69-70, 74-77.

a. The FAC does not allege that the content of Defendants' business decisions was irrational or gross overreaching.

The case law (summarized above) and the statutes (Cal. Corp. Code §§ 309, 7231) provide no basis to second-guess the content of Defendants' business decisions. The FAC does not allege that Defendants did not do what they "believe[d] to be in the best interest of the corporation" (*Castetter*, 184 F.3d at 1044) or engaged in "gross overreaching" (*Ritter & Ritter*, 166 Cal. App. 4th at 123). The FAC alleges nothing to suggest the directors sought to harm WesCorp, did not believe in what they were doing (after all, their own institutions invested with WesCorp) or were grossly overreaching. What it does allege is a disagreement about the risk-reward tradeoff in business: how much risk to bear and how much reward to seek. FAC ¶¶ 25-30, 45-53. That is exactly what the Business Judgment Rule protects. The "core protections" of the Rule are "protections designed to allow corporate managers and directors to pursue risky transactions without the specter of being held personally liable if those decisions turn out poorly." *Citigroup*, 964 A. 2d at 125.

The NCUA does not like WesCorp's departure from its "traditional business model," its decision to borrow money (hardly a unique idea for a financial institution) or its search for higher yields (again, hardly a unique idea). With the full benefit of 20/20 hindsight, the NCUA claims these decisions led to large losses, although the allegations of loss are remarkably lacking in detail.

The FAC insinuates that because credit unions are non-profits, WesCorp should not have taken risks or sought higher yields. FAC ¶¶ 24-27. (One supposes a financial institution could avoid all risk if it did not lend money or invest money.) But the FAC does not allege that WesCorp's strategy was a

secret,[3] that WesCorp violated any NCUA statute (they specifically authorize investments in private-label MBS, *see* 12 U.S.C. § 1757(15)(B)) or any NCUA regulation (of which there are hundreds, *see* 12 C.F.R. Parts 700-797, including many regulating investments, *see* 12 C.F.R. § 704.5 (Oct. 25, 2002), 704.6 (Oct. 25, 2002), 704.8 (Oct. 25, 2002), 704.10 (Mar. 19, 1997) & Part 704, Appx. B (Oct. 25, 2002); *see also* 12 C.F.R. §§ 703.1-703.19 (Jan. 3, 2003)), or that offering higher yields to natural person credit unions that wanted higher yields was somehow unlawful.

The whole tenor of the FAC is that the NCUA would rather WesCorp have been more traditional and more risk-adverse (lower leverage, lower yield). But as explained in *Citigroup*, that is exactly that sort of hindsight-fueled second-guessing that courts should avoid. The NCUA is not entitled to seek billions of dollars from well-meaning individuals merely because the NCUA now suggests it would have made different choices had government bureaucrats run WesCorp.

b. The FAC does not allege fraud, bad faith or conflicts of interest.

The FAC makes, with respect to these defendants, no allegations of fraud, bad faith or conflicts of interest. Nor could it. These defendants (except Burrell, who is discussed below) were unpaid volunteers (*see* 12 U.S.C. § 1761(c)), CEOs or CFOs of natural person credit unions chosen by member credit unions to serve on WesCorp's Board (*see* 12 U.S.C. § 1761(a)). There is not even a whiff of self-dealing or self-interest around them. They are simply good citizens who tried their best to oversee the management of the money their own credit unions had entrusted to WesCorp. They had "skin in the game" and no ulterior motives, and the FAC does not allege otherwise.

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[3] At all times, the NCUA had at least two examiners resident at WesCorp, and it conducted periodic regulatory examinations of WesCorp. The FAC does not allege either that it criticized WesCorp when WesCorp was buying MBS (before the summer of 2007) or that WesCorp failed to respond to whatever suggestions the NCUA offered in its reports of examination.

c. The FAC's process allegations not do overcome the Business Judgment Rule.

To the very limited extent that the FAC actually does address process, the FAC fails to allege lack of a reasonable inquiry. As explained in *Lee,* it is not enough to allege a failure to conduct an active investigation without also alleging (1) facts which would reasonably call for such an investigation or (2) facts which would have been discovered by a reasonable investigation and would have been material to the questioned exercise of business judgment. *Lee*, 50 Cal. App. 4th at 715. The FAC alleges no such facts. Instead, and as in *Lee*, what the FAC offers is merely the conclusion that there "was not a reasonable inquiry because the defendants reached a conclusion with which the plaintiffs disagree." *Id.* at 716. That kind of wishful thinking does not suffice, said *Lee,* in upholding the sustaining of a demurrer. The same is true here.

Before turning to the FAC's criticisms of Defendants' processes, it is useful to recall what the FAC concedes. It *admits* that:

- Defendants received detailed information about WesCorp's investment portfolio, set, monitored and followed appropriate concentration limits, monitored trends and reacted to trends (lowering their exposure to AA-rated securities after 2005 and ceasing MBS purchases altogether long before most on Wall Street). *E.g.*, FAC ¶¶ 32, 62-66, 69-70, 74-77.
- WesCorp classified and tracked MBS investments by rating (AAA and AA) and FICO score (prime, alt-A and subprime), and used the bond rating of investments to track tranche positions. FAC ¶¶ 71-72.
- Each year, Defendants adopted a budget that contained detailed information about projected expenses and projected fee income, including monthly projections of investment income, investment expense and net interest income. FAC ¶ 65.
- Defendants regularly attended meetings of WesCorp's Board of Directors and

ALCO, and regularly received information about the state of the economy, the investment climate and WesCorp's investment strategy. FAC ¶ 74.

- Defendants received and considered presentations on Option ARM MBS and took affirmative steps to adjust WesCorp's investment strategy based on the information received at ALCO meetings (*e.g.*, starting to get out of AA in 2005). FAC ¶¶ 62-64, 75-77.

This is not the portrait of a Board run amok.

As telling as what the FAC admits is what it omits: It does not allege any violation of the myriad NCUA regulations promulgated under 12 U.S.C. § 1766(a) detailing how a credit union should analyze, limit and monitor its investments. *See* 12 C.F.R. Part 704; *see also id.* Part 703. Consider this:

- The NCUA's regulations expressly contemplate and authorize investments in private-label MBS. 12 C.F.R. § 704.5(c), (h) (Oct. 25, 2002) (specifying kinds of MBS allowed, and not allowed) & Part 704, Appx. B (Oct. 25, 2002); *see also id.* § 703.2 (June 3, 2003) (definition of "Mortgage related security"), § 703.14(d) (June 3, 2003) (CDOs), § 703.16(d)-(f) (June 3, 2003) (specifying kinds of MBS that are not allowed).
- The NCUA's regulations set concentration limits (*id.* § 704.6(c) (Oct. 25, 2002)) and discuss how to analyze concentration risk (*see id.* § 703.3(f) (June 3, 2003)).
- The NCUA's regulations also require prompt reporting to the NCUA of any investment that falls out of compliance or has its rating downgraded below the approved level (*id.* § 704.10 (Oct. 25, 2002); *see also id.* § 703.7 (June 3, 2003)).
- Until 2002, the NCUA's regulations only permitted investments rated "AAA" and up (*see* 12 C.F.R. § 704.6(d) (Mar. 19, 1997)).
- In 2002 – the year the FAC accuses WesCorp of becoming more "aggressive" (FAC ¶¶ 25, 45) – the NCUA lowered its rating requirement to "AA minus"

for all corporate credit unions (*id.* § 704.6(d)(2) (Oct. 25, 2002)) and "BBB" for credit unions (such as WesCorp) given expanded investment authority under Appendix B to Part 704 (*id.* Part 704, Appx. B (Oct. 25, 2002)).

- The NCUA withdrew permission for qualifying corporate credit unions to invest in BBB-rated securities only 12 days ago, on October 20, 2010, and the new rules do not go into effect until January 2011. *See* 75 Fed. Reg. 64851 (Oct. 20, 2010).
- The FAC does not mention that at all relevant times, the NCUA gave WesCorp the highest level of expanded investment authority, including permission to buy securities rated as low as BBB, and that the NCUA therefore subjected WesCorp to the very highest level of regulatory scrutiny, including on-site NCUA examiners who had real-time access to all ALCO and Board reports, and daily access to WesCorp personnel.
- But the FAC does allege that "the lowest tranche MBS purchased were rated AA" (not BBB, as the NCUA permitted until 12 days ago) and admits that WesCorp acted to reduce its holdings of AA after 2005. FAC ¶¶ 62-64.

The FAC does not allege that Defendants violated any of these or the myriad other regulations and directives detailing how Defendants were to do their jobs.

With all these admissions and omissions, what does the FAC criticize?

The FAC concedes that WesCorp's annual budget contains detailed information about projected expenses and fee income, as well as projected monthly investment income, investment expense and net interest income, but the FAC criticizes the budget for not being more detailed about how changes in the composition of investments might affect these monthly projections. FAC ¶ 65. Such nit-picking cannot satisfy the standard set by *Lee*: the allegations do not specify what red flags warranted such additional analysis, or how such additional analysis would have affected an investment decision. *See Lee*, 50 Cal. App. 4th at 715.

Similarly, the FAC admits that WesCorp tracked and periodically reviewed the ratings and other characteristics of its investments, but argues that Option ARMs and lower-tranche MBS should have been tracked separately. FAC ¶¶ 71-72, 113, 114(e). Again, these allegations fail to satisfy *Lee*: the FAC alleges no facts showing that, *at the time*, such additional tracking was called for or that such additional tracking would have uncovered something material. *Lee*, 50 Cal. App. 4th at 715-16.

Especially in hindsight, any management report could be improved. After all, given all the time and money in the world, there always is something more that could done, or done a little differently. But failing to find and analyze every single piece of information that could possibly be uncovered by additional inquiry is not the standard by which directors' acts must be judged. The Business Judgment Rule does not require that directors conduct "the ideal or perfect investigation – one that can anticipate all suggestions and withstand any criticism . . . of future court review. What is required is that the corporation makes a *reasonable* effort to reach an informed business decision." *In re Consumers Power Co. Derivative Litig.*, 132 F.R.D. 455, 483 (E.D. Mich. 1990) (emphasis in original). Indeed, "in the world of business (as elsewhere), persons are often (or always) required to act on less than perfect information" *Estate of Detwiler v. Offenbecher*, 728 F. Supp. 103, 152 (S.D.N.Y. 1989) (citation omitted). The FAC's nit-picking cannot overcome the Business Judgment Rule.

The same is true of the FAC's conclusory and fact-bare suggestion that Defendants did not understand what they were doing. FAC ¶ 113. In *Castetter*, the FDIC attempted to show that a failed bank's directors did not comprehend the information that they received, failed to understand their core business, and accordingly failed to adopt proper policies concerning loans, capital adequacy, collections and internal controls. *Castetter*, 184 F.3d at 1045. The Ninth Circuit held that such evidence did not establish a claim because it bears on the

soundness of the directors' actions, not on the process of making an adequate inquiry. *Id.* So too here. Condescension about Defendants' understanding is no substitute for an adequate complaint.

Because Defendants were disinterested and made good-faith decisions based on a reasonable inquiry, the Business Judgment Rule insulates them from a claim for ordinary negligence and breach of the duty of care. The NCUA has not pleaded facts adequate to show that it is "plausible" (within the meaning of *Twombly*, 550 U.S. at 555-56; *see also Moss*, 572 F.3d at 969) that it will succeed on the First Claim. Therefore, the First Claim should be dismissed.

d. The FAC fails to allege facts particular to Burrell.

Robert Burrell was an officer and not a director. Courts have held that both directors and officers are fiduciaries (*Gantler v. Stephens*, 965 A.2d 695, 708-09 (Del. 2009)) and both also enjoy the protection of the Business Judgment Rule (*McMichael*, 2001 U.S. Dist. LEXIS 3918, *31 (holding that "the business judgment rule attaches to protect corporate officers and directors and the decisions they make, and courts hesitate to second-guess such decisions")).

But that does not mean fiduciary duty claims against officers can just piggyback on claims against directors. Instead, a claim against an officer must "allege facts demonstrating that (1) he took part in the challenged conduct and (2) failed to demonstrate the due care attendant to his particular office in doing so." *Bridgeport Holdings, Inc. Liquidating Trust v. Boyer*, 388 B.R. 548, 573 (Bankr. D. Del. 2008). The reasoning is practical: "Different corporate offices obviously hold different responsibilities. For example, the responsibilities of [VP] of Marketing are not the same as those of a General Counsel." *Id.* To overcome a motion to dismiss, a complaint must describe "which office and which responsibilities each defendant allegedly held," because otherwise "it is not possible to discern what a particular defendant did or failed to do in the exercise of due care in his capacity as holder of that office." *Id.*

The FAC fails this test. It does not describe the roles of any officer; it does not allege which decisions they made; it says very little about them beyond their job titles. For example, it fails to allege that Burrell had any specific duties or responsibilities subjecting him to a different or higher standard of fiduciary duty. It also does not allege any acts by Burrell that breached any duties. Indeed, he is mentioned by name only in the paragraphs identifying him as a party and mentioning his responsibility for meeting earnings goals. FAC ¶¶ 8, 67. By failing to allege a duty or its breach, the FAC states no negligence claim at all against Burrell, much less one that overcomes the Business Judgment Rule.

B. The FAC's Second Claim does not state a claim for gross negligence because California law does not recognize a general claim for gross negligence and because the FAC does not allege facts amounting to gross negligence.

1. The federal statutory floor does not apply in California.

Under federal statutes such as 12 U.S.C. § 1787(h), "state law sets the standard of conduct as long as the state standard (such as simple negligence) is stricter than that of the federal statute. The federal statute nonetheless sets a 'gross negligence' floor, which applies as a substitute for state standards that are more relaxed." *Atherton*, 519 U.S. at 215. Here, California law is stricter than gross negligence. *Castetter*, 184 F.3d at 1043-44. Thus, under *Atherton* there is no need or occasion to resort to the federal floor. This without more defeats the Second Claim, which purports to invoke section 1787(h). FAC ¶ 119.

2. California law does not recognize a general claim for gross negligence.

If there were occasion to resort to section 1787(h), then the NCUA would face another obstacle. Section 1787(h) says "gross negligence" is "defined and determined under applicable State law." Here, that is California law. FAC ¶ 112. But California does not recognize any general claim of "gross negligence." *Martinez v. United States*, No. EDCV 09-0375-SVW(RC),

2010 U.S. Dist. LEXIS 105763, *20-*21 (C.D. Cal. Mar. 25, 2010); *Saenz v. Whitewater Voyages, Inc.*, 226 Cal. App. 3d 758, 766 n.9, 276 Cal. Rptr. 672, 677 n.9 (1991); *Continental Ins. Co. v. Am. Prot. Indus.*, 197 Cal. App. 3d 322, 330, 242 Cal. Rptr. 784, 789-90 (1987).

Thus, there is no need to resort to a gross negligence claim under *Atherton*, and no gross negligence claim to resort to under California law. For either reason, or both reasons, the Second Claim fails as a matter of law.

3. The FAC does not allege facts amounting to gross negligence.

Even if there were not these two legal bars to alleging a claim for gross negligence, the FAC simply does not allege facts amounting to gross negligence under any recognized definition – California, Delaware or otherwise.

California courts have not defined gross negligence in the director context, presumably because California does not recognize such a claim. But various California statutes do use the term in other contexts,[4] and California courts have had occasion to define "gross negligence" as a "want of even scant care" or "an extreme departure from the ordinary standard of conduct." *City of Santa Barbara v. Superior Court*, 41 Cal. 4th 747, 754, 62 Cal. Rptr. 3d 527, 532 (2007) (quotations omitted).[5]

Delaware courts define gross negligence in the corporate context as "a reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason." *In re Walt*

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[4] *E.g.*, Cal. Bus. & Prof. Code §§ 2533 (speech-language pathologists and audiologists), 2563 (contact lens dispensers), 3401 (hearing aid dispensers), 3137 (optometrists).

[5] California courts also recognize the propriety of dismissing on motion a complaint that fails to allege facts demonstrating an extreme departure from the ordinary standard of conduct. *Devito v. California*, 202 Cal. App. 3d 264, 272, 248 Cal. Rptr. 330, 335 (1988); *see also Eastburn v. Regional Fire Protection Authority*, 31 Cal. 4th 1175, 1185-86, 7 Cal. Rptr. 3d 552, 661-62 (2003).

Disney Co. Deriv. Litig., 907 A.2d 693, 750 (Del. Ch. 2005) (holding that nine-figure severance payment to fired executive was not actionable as gross negligence) (citation omitted). The FAC cannot conceivably be read to allege anything that comes close to being "want of even scant care," an "extreme departure from the ordinary standard of conduct," "reckless indifference," "deliberate disregard" or "without the bounds of reason."

RTC v. Blasdell, 930 F. Supp. 417 (D. Ariz. 1994) also is instructive. There the RTC alleged that the directors of a failed bank had failed to adopt adequate lending policies and procedures, but evidence showed that the directors had enacted some policies and procedures, had adjusted those policies and procedures to address the concerns of regulators, had attended board meetings at which they reviewed and considered relevant and sufficient materials when making decisions, but nonetheless made some arguably improvident loans. *Id.* at 426-27. The court held that the evidence simply did not support allegations that directors abdicated their responsibilities or were grossly negligent. *Id.*

Under any of these definitions, the FAC's allegations do not amount to gross negligence. The FAC admits that Defendants adopted a yearly budget that contained detailed information about projected expenses and projected fee income. FAC ¶ 65. The FAC admits that Defendants adopted policies specifying concentration limits for its investment securities and periodically amended the policies to change limits or impose new limits. FAC ¶ 69. The FAC admits that Defendants tracked and reported investments by rating (AAA or AA) and by FICO score (prime, alt-A, and subprime). FAC ¶ 71. The FAC admits that Defendants adopted concentration limits for the investments at issue, and did not exceed them. FAC ¶¶ 69, 73. The FAC admits that Defendants attended ALCO meetings, where they received presentations about the state of the economy generally and WesCorp's investment strategy specifically. FAC ¶ 74. And the FAC admits that Defendants adjusted WesCorp's investment

strategy based on the information presented at the ALCO meetings, first decreasing investments in AA-rated securities and then stopping investments in MBS altogether. FAC ¶¶ 62-64, 75-77.[6] As shown in part III.A.2.c above, the FAC's only allegations of process deficiencies are either wholly conclusory or else are nit-picking that cannot rise even to the level of ordinary negligence, let alone a "want of even scant care" or "an extreme departure from the ordinary standard of conduct." *City of Santa Barbara*, 41 Cal. 4th at 754.

Because the FAC does not allege facts to show that it is "plausible" that Defendants were grossly negligent, the FAC's Second Claim must be dismissed.

As with the fiduciary duty claim, the FAC does not describe the duties of each officer sufficient to state a claim for gross negligence. To plead negligence, a complaint must actually allege a duty. *Martinez*, 2010 U.S. Dist. LEXIS 105763, at *20-*21. The FAC does not do so.

C. The FAC's First and Second Claims are time-barred as against Cheney, Updike and Rhamy.

The NCUA has three years from the date of the conservatorship (March 19, 2009, *see* FAC ¶ 1) to bring claims against directors and officers. 12 U.S.C. § 1787(b)(14). But it can only assert claims that were not time-barred as of the date of the conservatorship; section 1787(b)(14) does not resurrect from the dead claims that were time-barred as of that date. *FDIC v. McSweeney,* 976 F.2d 532, 534 (9th Cir. 1992). The question is thus whether the NCUA's claims were time-barred under state law as of March 19, 2009, bearing in mind

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[6] As noted, the FAC alleges that WesCorp departed from its traditional business model. FAC ¶ 25. Merely departing from a traditional business model is not gross negligence. *See Trenwick Am. Litig. Trust v. Ernst & Young LLP*, 906 A.2d 168, 194 (Del. Ch. 2006). That is especially true where, as here, WesCorp's brief foray into AA-rated investments occurred only after the NCUA changed its regulations to permit investments rated as low as BBB. See part III.A.2.c above.

that the FAC alleges that Cheney left the WesCorp Board in February 2006 (three years and one month before March 2009), and Rhamy and Updike left the WesCorp Board in April 2006 (two years and eleven months before March 2009). FAC ¶¶ 17, 20-21.

The FAC is highly ambiguous as to who allegedly did what, or when. Given this ambiguity, one cannot tell whether Cheney, Rhamy and Updike are accused of any actionable acts or omissions within any limitations period. But if the applicable statute of limitations is three years or less (in the case of Cheney) or two years or less (in the case of Rhamy and Updike), then the limitations period begins *after* they left WesCorp's Board. If so, they cannot possibly be liable to the NCUA for anything.

First Claim: The limitations period for the First Claim should be two years; California authority – on this point of California law – holds that the proper limitations period for a breach of fiduciary duty claim against a corporate director is two years, under Code of Civil Procedure section 339. *Burt v. Irvine Co.*, 237 Cal. App. 2d 828, 865-67, 47 Cal. Rptr. 392, 415-17 (1965); *Southern Counties Thrift Co. v. Rairdon*, 47 Cal. App. 2d 770, 771, 118 P.2d 828, 829 (1941); 3 B.E. Witkin, *California Procedure*, Actions § 650, at 858 (5th ed. 2008). But *McSweeney* (which did not discuss either *Burt* or *Southern Counties*) holds that the statute of limitations is four years under California's catchall statute of limitations, Code of Civil Procedure section 343. *McSweeney*, 976 F.3d at 534-36. Defendants Cheney, Rhamy and Updike recognize that this Court is constrained to follow *McSweeney* as binding precedent and therefore must rule against them on this point. *Id.* They make this argument simply to preserve it for appellate purposes. *See United States v. Zuniga*, 579 F.3d 845, 847-48 (8th Cir. 2009); *cf. Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 484, 109 S. Ct. 1917, 1920-21 (1989).

Second Claim: The limitations period for the Second Claim is either two

years or three years, which means that the Second Claim must be dismissed against Cheney, Rhamy and Updike (if two years) or Cheney only (if three years). California law does not have a limitations period for a claim of gross negligence because California does not recognize a separate tort of gross negligence. *See* authorities cited in part III.B.1 above. Hence the lack of certainty as between two years and three years.

Two years: Although gross negligence is not a separate tort in California, it is akin to simple negligence, being the more egregious form of the same thing. *Continental Ins. Co.*, 197 Cal. App. 3d at 330.[7] California's statute of limitations for claims of simple negligence in the context of a directors' duties is two years. *See McSweeney*, 976 F.2d at 534. Thus, if a claim for gross negligence should be recognized at all (and it should not, for the reasons stated in part III.B.1 above), the statute of limitations for a claim of gross negligence also should be two years.

Three years: Alternatively, and if, despite the arguments above, the Court were to hold that a claim for gross negligence exists under 12 U.S.C. § 1787(h) even though it does not exist under California common law, then that claim must be a creation of section 1787(h). If so, Code of Civil Procedure section 359's three-year statute of limitations would apply. That statute applies to "actions against directors … to enforce a liability created by law … ." Civ. Proc. Code § 359. California courts construe the words "liability created by law" to mean a statutory liability first authorized by a statute or the Constitution, as opposed to one that existed at common law and was merely codified by statute; but California courts have split over section 359's applicability to Corporations Code section 309. *Compare Smith v. Superior Court*, 217 Cal. App. 3d 950, 953-54,

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[7] As an English judge once famously put it, gross negligence is simply ordinary negligence "with the addition of a vituperative epithet." *Wilson v. Brett*, [1843] 11 M. & W. 113, 116, 152 Eng. Rep. 737 (Rolfe, B.) (quoted in *Archie v. City of Racine*, 847 F.2d 1211, 1219 (7th Cir. 1988)).

266 Cal. Rptr. 253, 254-55 (1990) *with Lehman v. Superior Court*, 145 Cal. App. 4th 109, 114-22, 51 Cal. Rptr. 3d 411, 413-20 (2006) and *Briano v. Rubio*, 46 Cal. App. 4th 1167, 1173-80, 54 Cal. Rptr. 2d 408, 411-15 (1996). While these three opinions disagree as to whether section 359 applies to section 309, all three opinions agree that section 359 would apply to a statutory standard of director liability without common-law roots. Because Section 1787(h) would not simply be a codification of a common-law principle, section 359 would apply to a claim based on section 1787(h).

If the limitations period is two years, the Second Claim must be dismissed as to Cheney, Updike and Rhamy. If, however, the limitations period is three years, the Second Claim must be dismissed as to Cheney.

D. Dismissal should be without leave to amend.

Defendants recognize the policy of liberality when it comes to granting leave to amend. But that policy has its limits. It is one thing to treat liberally a private plaintiff who has been forced to plead a claim against corporations or their directors without any access to the corporation's records. *Cf. Eminence Capital, LLC v. Aspeon Inc.*, 316 F.3d 1048 (9th Cir. 2003). But it is another thing to extend the same liberality to a government agency that has had the run of WesCorp for the last year and a half, with complete access to all its books and records, and the untrammeled ability to interrogate its employees without anyone representing Defendants in the room. Where there is no reason to think amendment would cure the defects, there is no reason to grant leave to amend, even the first time around. *Cf. In re Hansen Natural Corp. Sec. Litig.*, 527 F. Supp. 2d 1142, 1163 (C.D. Cal. 2007). This is such a case.

IV. CONCLUSION.

When big losses occur, there is an all-too-human desire to find scapegoats. Doubtlessly WesCorp made some investment decisions that, with 20/20 hindsight and full knowledge of the credit crisis of 2008-09, one might wish it

had not made. But it is one thing to regret an investment and quite another to ask a group of unpaid volunteer directors to ante up $6.8 *billion* in damages for having made, in perfect good faith, some investment decisions that did not work out as one might have hoped. The NCUA knew then what Defendants were doing and how they were doing it. It therefore has no business suing them now for billions of dollars on account of business decisions that the NCUA's statutes and regulations and its examiners permitted – and indeed applauded – at the time.

For each of the foregoing reasons, the FAC should be dismissed without leave to amend.

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